DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

36 Letters per Year – $75 Annually

Registered with the Securities Exchange Commission

September 8, 1972 Letter 540

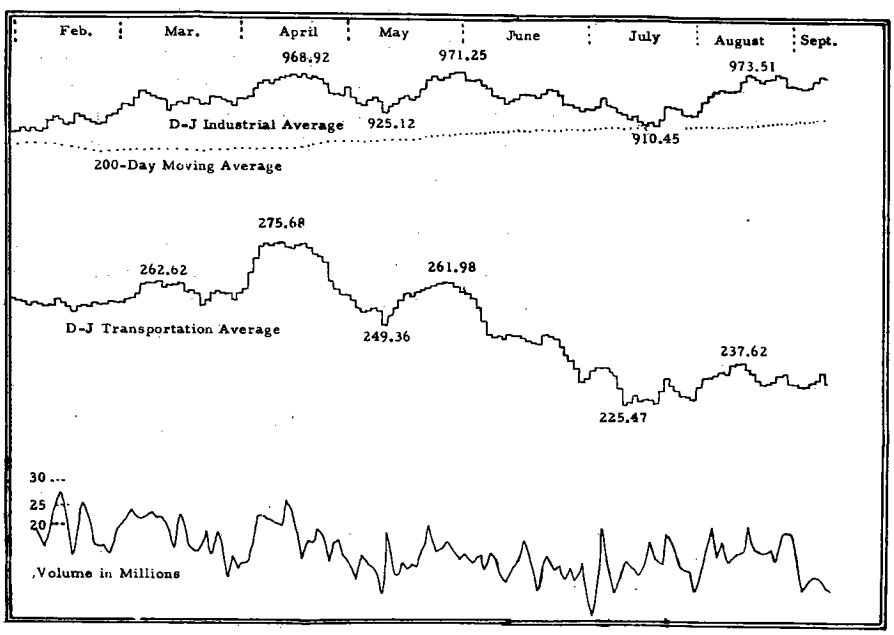
Aug. 25, Dow 959.36, PTI 976, A-D Ratio - 1.88
Sept. 1, Dow 970.05, PTI 982, A-D Ratio - 1.78

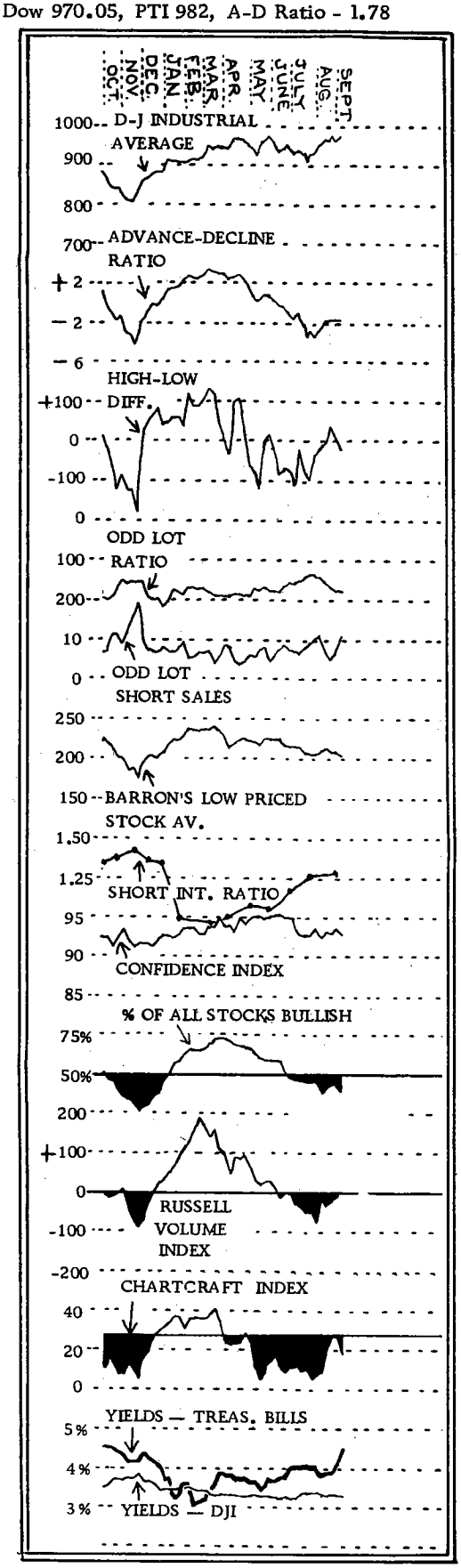
THE MARKET: "The stock market indicators are seldom wrong, it's the people who interpret them who make the mistakes." This is an aphorism which I used to hear frequently during the 1950's, but today, with the competitive frenzy to call every 10-point swing in the Dow, one rarely hears anything that modest. Many of the more recent advisory services have put themselves in a position wherein they have to be short-term geniuses; they feel this is the way to sell a new service. But I usually find this type of writing a mixture of posturing, half-truths, inexperience and pure ignorance.

The fact is that Wall Street has always been a matter of probabilities and percentages. The day that someone invents the perfect "system" (long term or short) for beating the market will mark the beginning of the end for the securities industry. For obviously, the inventor of the perfect system will own all the nation's wealth in a matter of months. It's as simple as that.

So until the perfect system is invented, we poor mortals will have to depend on art, intelligence, charts and seat-of-our-pants intuition. With this in mind, I note that the current consensus has it that the Dow will move into the 1050 to 1100 area before year-end, with some analysts even promising 1200 on the Dow by early 1973. All this may come to pass, but so far the technical action of the market suggests to me that it will not.

The outstanding feature of this market is its "split" or schizophrenic action. In the last Letter I went into detail regarding the upside movement in a select number of heavily weighted issues, this while the great majority of stocks milled about aimlessly or actually declined. Nothing has changed since the last Letter, and I would say that shares are being distributed under the guise of strength in the Dow Industrials.





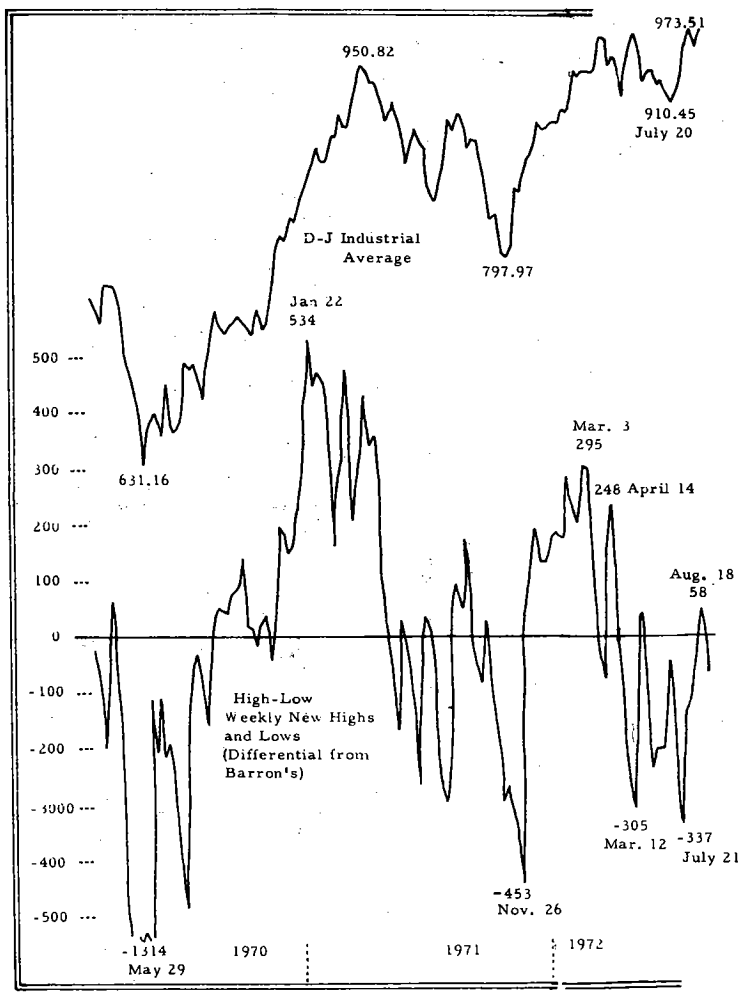
Turning to the weekly chart of the Averages and the A-D ratio on this page, it is obvious that none of the other indices are offering any real support for the Dow (although Utilities have at least rallied off their 1972 lows). The A-D ratio is still outstandingly weak, having barely pushed above its July 31 low for the year, despite the fact that the Dow has rallied 60 points above its own July low.

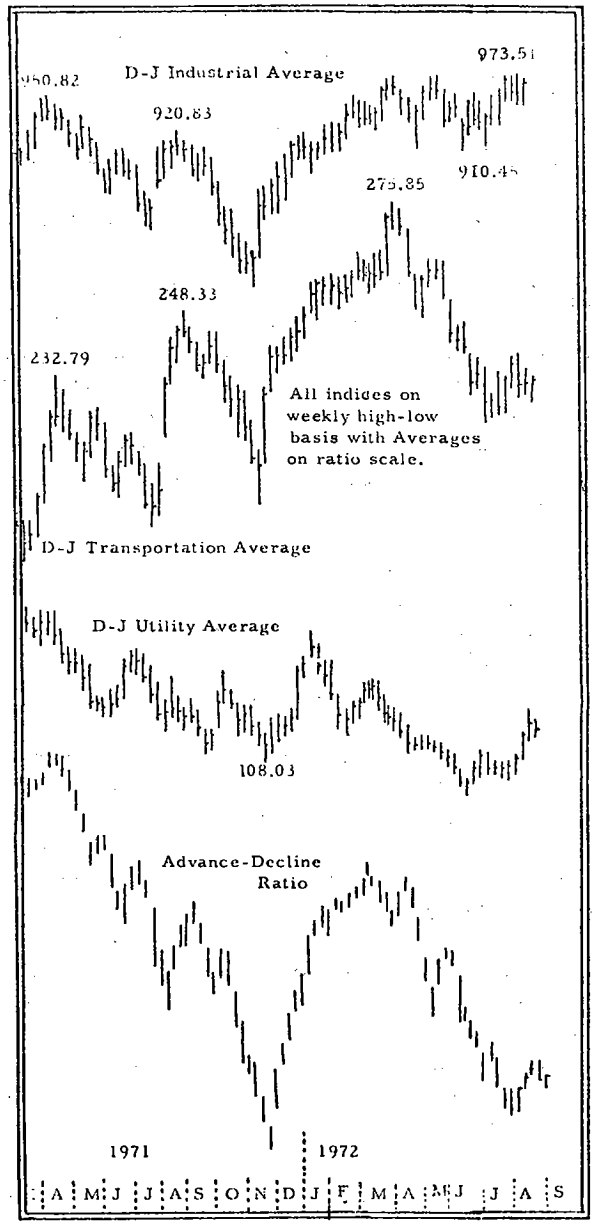
The position of the Transports can best be seen on the page 1 (daily) chart. Transports have been stubbornly reluctant to confirm the Industrial Average. Even the August 11 Transport "mini-peak" of 237.62 has proved to be an upside barrier, to say nothing of the April 12 high of 275.71. With Industrials having bettered their own April and May highs, it is clear that the Transports are nowhere near confirming the senior average.

In Letter 539 I drew attention to the very poor performance of the daily new highs, and I included a tabulation of my 5-day average of new highs showing that highs had dropped off on each successive Dow peak since March 6.

Perhaps, even more dramatic is the weekly high-low tabulation which is the differential between all highs and lows for each week (statistics carried in Barron's). I am including the chart of the weekly high-low differential, and here we can see the dramatic decline in the upside momentum of the general market as measured by the decline in the high-low differential.

To recount a little history, on the week ending March 3 with the Dow





at 942 we had 295 more highs than lows. On the week ending April 14 with the Dow at 967 we had only 248 more highs than lows. On the recent week ending August 18, with the Dow at 966, we had only 58 more highs than lows!

But the real shocker came last week or the week ending September 1. With the Dow closing at 970, we actually had 70 more lows than highs. This is one of the worst performances near a Dow peak that I have ever seen. No wonder the public is being hurt in this market. No wonder the funds are being ground to a standstill. The fact is that the high-low differential is merely confirming what the advance-decline ratio has been telling us. Since March of this year, the majority of stocks have been in downtrends. The majority have continued in downtrends until the July 31 low on the A-D ratio, and the rally since then has been outstanding for its sluggishness on the part of the great majority of issues.

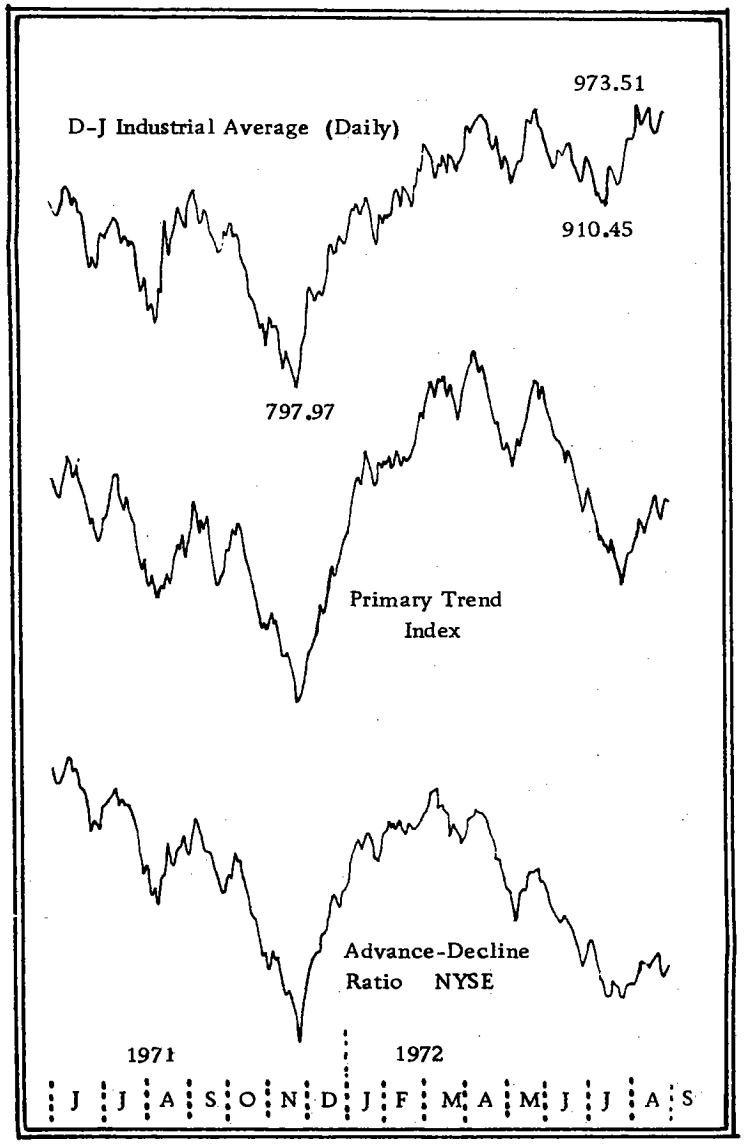
Subscribers may note in the upper right of page 1 that I have included the Friday closing for the Dow, the Primary Trend Indicator (PTI) and the A-D ratio. These figures will appear with each report (I have had many requests for them), and in this way subscribers may keep their own weekly charts, charts which should prove most valuable.

On this page I have included the daily movements of those three indicators, and it is obvious that the recent rally in the Dow has been unconfirmed by the other two indicators. In fact, the upside resistance shown by the PTI and the A-D ratio must be termed dramatic.

A few items on the page 1 Composite Chart are worth nothing at this time. First, the percentage of all NYSE stocks in bullish trends is now 41%, still well under the critical 50% level, despite the new Dow attack on the highs. Note also that this percentage is below the earlier bullish reading of March and April (when the Dow was at 968).

Second, the Chartcraft Index of indicators dropped back into bearish territory on the week ending September 1, down from 28 the previous week to 18 (28 represents the 50% level), so that at 18 only 32% of Chartcraft's indicators are bullish, a poor showing with the Dow near a recovery high.

Finally and very important, note that the bellwether 91-day Treasury bills have moved up to a high for the year at 4.5%. With Standard and Poor's broad 500 Stock Average at an all-time record low yield of 2.77% (!), there is an increasingly dangerous spread in yields between common stocks and Treasury bills (bills represent the peak in safety and liquidity).



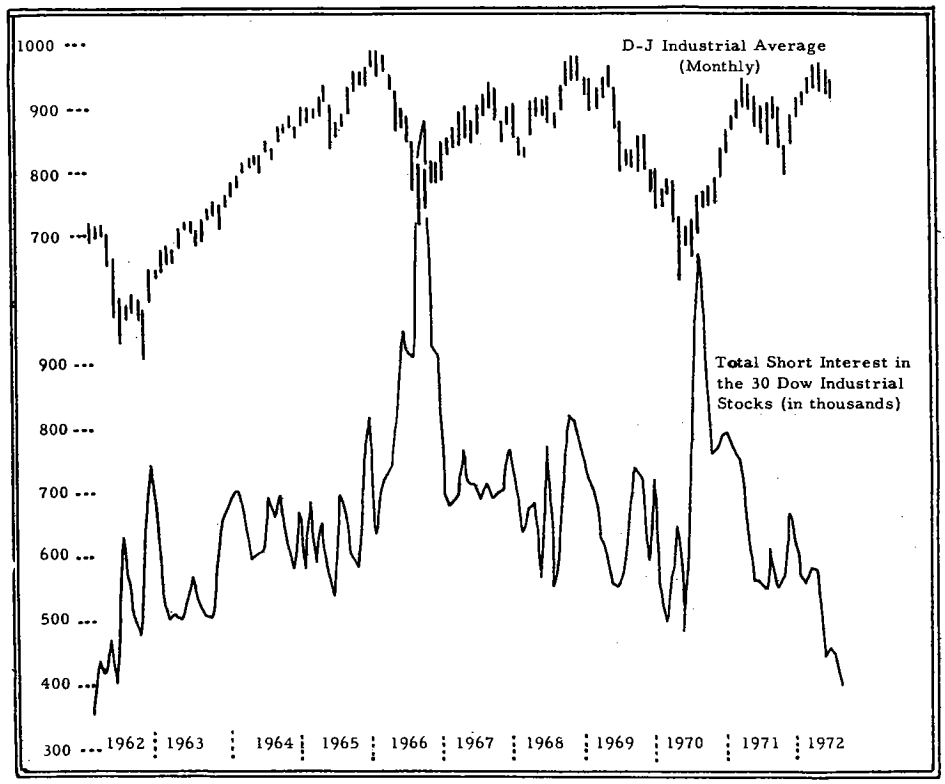
SHORT POSITION: I have been a student of the short position and the short ratio for many years. In fact, an article I wrote for Barron's 13 years ago ("Tell Tale Ratio") helped popularize the whole study of the short interest. But nothing is ever cut and dry in the stock market. Even in those days some of us noticed the steadily rising arbitrage positions which show up deceptively as part of the total NYSE short total.

Veteran market analyst Garfield Drew ("Are you there, Jeff?") even started a special tabulation of the short interest in 13 key stocks, issues like US Steel, Telephone, General Electric, etc. Drew started this special short tally in 1958, and he has kept it up ever since. Last week I was interested to note that Drew's special tally dropped to its lowest short total since the index was first published 14 years ago.

In his report of August 26, Drew (Drew Odd Lot Studies, 50 Congress St., Boston, Mass.) makes some very interesting observations regarding the latest short interest total on the NYSE. He states, "Large arbitrage situations dominate the figures. Shorts in Amer. Tel. warrants (made largely against purchases of the stock) rose to 1,170,000, while Occidental Pet. leaped its short by about 860,000. Just these two account for more than 10% of the total. To break it down further, the August report shows 34 stocks with at least 6 figure short positions. These few issues represent 43.7% of the total. All but 7 were involved in situations inviting substantial arbitrage sales..."

Readers know that I place more importance on Bill Gordon's Short Interest Ratio of the 30 Dow Industrial Stocks. I have been showing these figures for years. By the way, the latest short ratio for the 30 Dow Industrial Stocks (mid-August figure) is .37, the third lowest figure on record! In case this low figure does not surprise my readers, I have drawn a chart (this is a chart never seen before) of the actual monthly short totals in the 30 Dow Industrials since 1962 (chart on page 4).

As of mid-August, 1972, the total number of shorts in the 30 Dow Industrials had dropped to 398 thousand, lowest figure in a decade (I remember when US Steel alone had over 100,000 shorts, back in 1958). Thus, I consider the technical underpinnings of this market very poor, with the extremely low short interest in the Dow stocks indicating that there is almost a complete dearth of bearishness regarding the D-J Industrial Average.



The last time the Dow short interest total sank under 400,000 was in early 1962 (see chart), just before the crushing 1962 decline. And 1962 was a time when average trading volume was far under what it is today. On a relative basis, the short interest in the Dow Industrials today should be much higher (and of course that is exactly why the Dow short interest ratio is in such bearish territory today. Remember, a short position in a market trading an average of 5 million shares a day is much more impressive than the same short position in a market trading an average of 10 million shares per day).

MARGIN VULNERABILITY: On Wall Street the "unexpected" is always the factor to watch out for. And when it happens, the question is — what kind of shape is the market in to receive it? I had been studying some of the margin statistics pertaining to the NYSE when the New York Times arrived, and I noted this little clip regarding margins. I thought it was interesting enough to include here.

Then last week E. George Schaefer's report arrived (Schaefer, 910 E. 38 St., Indianapolis, Ind. 46205), and he noted that the all-time high for the actual number of margin accounts was reached in December, 1968. At that time there were 945,000 margin accounts on the NYSE. After the 1969-70 crash, roughly 300,000 margin accounts were either wiped out or simply "disappeared." At any rate, following the 354 point market drop the number of margin accounts declined to 650,000.

Today, the number of margin accounts has risen to 725,000, about 125,000 more than at the crash bottom but still many less than at the 1968 high. Yet here is the interesting thing. The amount of margin debt outstanding (see news clip) now stands at a record $7.6 billion, or more than the total margin debt at the 1968 highs.

What this means, of course, is that the average margin customer now has more debt outstanding than he did at the 1968 peak. But there is another very important factor. At the 1968 peak customers were on 80% margin (they had to put up $80 for every $100 of stock they owned). However, now in 1972 margin requirements are at 55%. Thus, with more margin debt outstanding, 1972's margin customer is on vastly thinner ice than was the margin customer of 1968.

*

Margin-Debt Peril

During the panic of 1970, when stock market values fell more dramatically than at any time since 1929, many observers believe that margin calls were primarily responsible for the lowest prices reached in that black period.

This happened even though the margin requirement was at the 80 per cent level—meaning that investors having stocks in initial purchases had to put up $8 cash for every $10 of purchase price.

Now the margin requirement on initial purchases is 55 per cent, leading the observers to wonder whether the market isn't vulnerable to a surprise event. Initial selling on bad news might trigger margin calls and lead to a route—à la 1970.

The latest report from the New York Stock Exchange, dated August 14, showed that margin debt rose $150-million during July to a record $7.66-billion. It was the eighth consecutive monthly advance. More alarming still, 11 per cent of the margin accounts (responsible for 16 per cent of total margin debt) had equity of less than 40 per cent.

Customers generally don't have to reduce their margin debt unless their equity gets below 35 per cent. So margin levels can and do drop without triggering margin calls in a down market.

Although margin levels, under the rules, can drop to 25 per cent before the customer is sold out, well-managed brokerage firms seek additional margin when the equity falls below 35 per cent. Practically all firms call when the equity drops below 30 per cent.

Thus, margin accounts under the 40 per cent level are sharp sell-off in the market. A man in this position with a $40 stock will get a margin call if the stock drops 4 points—10 per cent. In these days, when glamour stocks take a pounding on disappointing earnings, the gravity of the situation is obvious.

Is this "thin ice" a factor in some of the recent sudden collapses in the glamor stocks and the flyers? I suspect it is, but so far the effects have been spotty and sporadic. How the market would act if selling became urgent I do not know, but I would say that the current erosion in the advance-decline ratio is becoming very important. Remember, the A-D ratio measures the direction of the majority of stocks on the NYSE. A continued decline in the A-D ratio is going to bring on a rising tide of daily new lows, and ultimately, a rising tide of margin calls.

POLITICS AND INFLATION: I have been amazed at the response I received regarding the last Letter (539) and the section on inflation entitled "The Thief." I have written about inflation many times, but somehow this piece seemed to have stirred readers all across the country. Evidently, the time for general fury and protest over inflation is drawing awfully close. Many readers wanted extra copies of Letter 539 ("with the charts of the dollar's erosion") to send to their friends.

The whole phenomenon is really a sad commentary on what is happening in America today. One can always ask the question, "Should the Government get its morality from the people, or should the people get their morality from the Government?" Actually, I believe that history demonstrates that the people most often get their morality from various great leaders. In the absence of outstanding government, a nation slowly sinks into the mire. The incredible thing about the US is that when outstanding leaders were needed they have always (at least in the past) appeared. We, of course, do not know whether fate will be so kind to us in the future (perhaps we citizens are supposed to be capable of picking and voting in superior leaders after almost 200 years of democracy)!

But matters seldom go by the textbook, either in economics, politics or anywhere else. Thus, I read in a report received last week (I don't know if this gentleman would want me to reveal his name), "The super rich run finance; finance runs politics; politics runs our government; our government runs the Internal Revenue Service; the Internal Revenue Service runs the taxpayer; the taxpayer runs, and runs, and runs — but he never wins."

Is my friend too cynical? Perhaps, but then why is inflation continuing, why is it that our Government is going to have to raise more than $35 billion next year, why did wholesale prices last month (July) jump at a seasonally adjusted rate of 8.4%, biggest rise since controls were imposed?

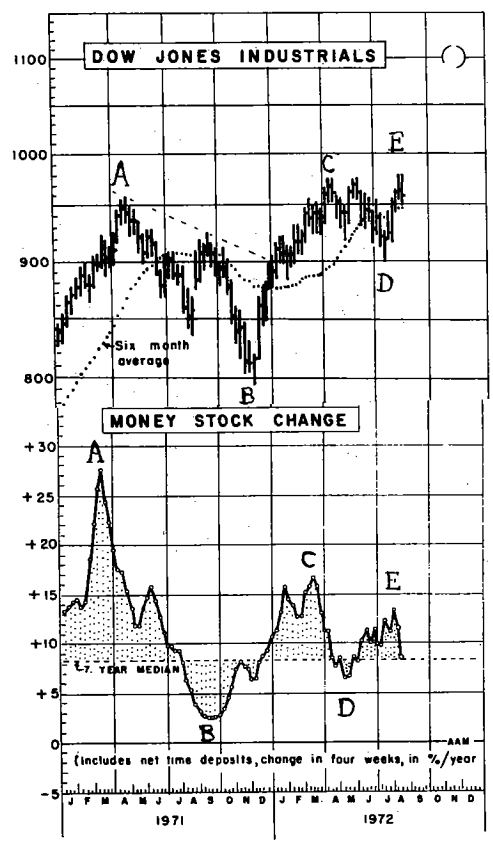
Will Mr. Nixon do anything about inflation after the election? (By the way, without meaning to be nasty or insidious I am currently writing off Senator McGovern as a contender. He simply isn't). My answer is that Nixon will have to do something about inflation after the election. The erosion of the dollar is progressing too rapidly, the economic picture is getting too frantic, the ice is too thin, and Mr. Nixon (during his second or "serious" term) will want to make his mark on history. History has been kind to Mr. Nixon so far, it has held off an economic (deflationary) collapse. I doubt that the economic forces will be so gentle during 1973.

One never knows where one will gather facts, and of all places I found the following interesting rundown in one of columnist Sylvia Porter's recent pieces:

Perhaps suspecting that matters could get totally out of hand by election time, the Federal Reserve Board has decided to attempt to cut back a bit on the money supply. In response to that kind of thinking and in response to the spector of massive borrowing needs during 1973, short-term money rates have started climbing with the bellwether 91-day Treasury bills now yielding 4.5%.

As a point of interest, I have reproduced a chart showing the change in the money stock. The chart (from Merrill Analysis, Box 228, Chappaqua, NY 10514) shows the recent drop-off in the rate of expansion. Much has been written about how the rate of change in the money stock serves as a good

At the end of the Truman administration (Jan. 1949-1953) the cost of living was up 10.8 per cent. At the end of the first Eisenhower term (Jan. 1953-1957) it was up 3.8 per cent and at the end of the second Eisenhower term (Jan. 1957-1961) up 7.8 per cent. At the end of the combined Kennedy-Johnson administration (Jan. 1961-1965) the cost of living was up 4.9 per cent; and at the end of the Johnson only administration (Jan. 1965-1969) it was up 13.9 per cent. At the end of the pre-NEP period of the Nixon administration (Jan. 1969-Aug. 1971) the cost of living rose 14.4 per cent, and since then (Aug. 1971 to mid-1972) it has gone up 2.4 per cent. Overall, during the Nixon adminsitration (Jan. 1969 to mid-1972) the cost of living went up 17.2 per cent.



leading indicator of stock prices. For this reason, I have superimposed Art Merrill's weekly chart of the Dow upon his money stock change chart. So far, the money change indicator seems to be an excellent advance indicator. And the latest decline from point D would seem to call for a decline in the market directly ahead. (I have marked corresponding points on the two charts with the letters A through E).

One of the hopeful (yet incredible) events of 1972 is the Republican inclusion in their platform of the right of US citizens to hold or buy and sell gold. I have reproduced the economic section of the platform as it appeared in last week's US News and World Report. This gold platform was put forth by Senator Allot of Colorado and was actually adopted. The question is why did the Republicans adopt it? My answer is that the politicians believe they can somehow take the mystique out of gold by making it freely available to American citizens. Secretly I believe they feel that freeing gold will bring down the price.

★ ECONOMY

"We stand for full employment—a job for everyone willing and able to work in an economy freed of inflation, its vigor not dependent upon war or massive military spending."

"We will fight for responsible federal budgets to help assure steady expansion of the economy without inflation."

Remove wage-price controls "once the economic distortions spawned in the late 1960s are repaired."

"The right of American citizens to buy, hold or sell gold should be re-established as soon as this is feasible."

As far as I am concerned, they could not be more wrong. If the private owner of a Matisse painting releases the painting for sale, will it go down in price? If any scarce commodity is put on the free market, will it go down in price? Only if it is overvalued in the eyes of the owner. Otherwise, the price of the commodity will move towards its real value, which is determined in the market place. Therefore, if gold is freed, I expect it to move up to much, much higher prices as citizens move in to store and hoard it and as they move out of fiat dollars. Then, the only way that the price of gold will hold stable is if the Government fixes it high enough so that there is no point in any further upside speculation. Such a price should be (in my opinion) above $150 per ounce.

But the important thing about the Republican gold platform is that it is a dramatic departure from the Government's position on gold. It is a definite step toward freeing gold from political manipulation, towards letting the market determine what it is worth, towards allowing all who want to trade or own gold to do so. At such time, gold will move towards and to its real market price and its true value.

GOLD-SILVER: As seen on the chart, gold is holding near its $70 high while silver is now moving up. As of September 5, the Reuters Gold Average of S. African shares was at a high for the year at 110.2. This is in contrast to the ADR's, which have been correcting sharply. My own conclusion is (see last Letter) that anything will serve to scare Americans out of gold shares. Those shares simply have no following or support here — yet.

NOTE: I am working on some very exciting new concepts in technical analysis of stocks, and it will concern the 30 Dow Industrial issues. The charts should allow for picking the strongest and weakest stocks in the Industrial Average. It will also allow us a new and penetrating view of the Industrial components.

THE PROPHET: William Butler Yeats wrote his great and prophetic poem, "The Second Coming," in the year 1919. Whether World War II, Korea, Vietnam, Ireland, or the tragic events of the 1972 Olympics were in Yeat's vision I do not know. I include four lines of that poem below:

"The Blood-dimmed tide is loosed, and everywhere
The ceremony of innocence is drowned:
The best lack all conviction, while the worst
Are full of passionate intensity."